1.03 Recognition & Measurement

When to Recognize Financial Statement Elements (SFAC 5)

- Meets definition – The item meets the definition of an element (asset, liability, etc.).
- Measurable – Element is capable of being measured in monetary terms.
- Relevant – The item is capable of making a difference in user decisions.
- Reliable – The information is faithfully represented and verifiable (ie, useful).

Measurement in Monetary Terms

- Historical cost – Amount paid (eg, PP&E)
- Replacement (current) cost – Cost to replace an item (eg, inventory)
- Fair Value (FV) – The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (ASC 820)—aka, Fair Market Value (FMV)
- Net realizable value (NRV) – Amount expected to be converted into (eg, A/R)
- Present Value (PV) – Discounted cash flows due to the time value of money (used for notes receivable, bonds payable, leases)

Revenue & Expense Recognition

Under the accrual basis of accounting, revenues are recognized in the period earned, regardless of when they are collected and expenses are recognized in the period incurred, regardless of when they are paid.

- *Revenue is* recognized when they are:
  - Earned – Earnings process is complete (goods delivered), and
  - Realizable (realized) – Collect cash or a claim to cash.
- *Expenses or losses* are recognized as incurred or when a loss of future economic benefits is discovered.
  - Economic benefit is used up (**consumed**) or assets lose future benefit (ie, it is evident that the future economic benefits of an asset have been reduced or eliminated).
    - Cause and effect – Expenses that produce revenue at identifiable points in time can be matched directly to revenues (eg, cost of goods sold).
    - Systematic and rational allocation – Expenses that produce revenue over long periods of time are matched to those periods using a reasonable means of allocation (eg, depreciation).
    - **Immediate recognition** – Some expenses cannot be directly related to specific benefits and are expensed as incurred (eg, monthly salaries of selling, general & administrative employees).

Using Cash Flow Info & PV in Accounting Measurements (SFAC 7)

When assets or services are exchanged for future cash, the most appropriate means of measuring the transaction may be the present value of future cash flows. For this reason, SFAC 7 introduces the expected cash flow approach, which:

- Provides a framework for using future cash flows as the basis for accounting measurements at initial recognition or fresh-start measurements and for the interest method of amortization.
- Differs from the traditional approach by focusing on explicit assumptions about the range of possible estimated cash flows and their respective probabilities.

> Fresh-start measurements establish a new carrying amount in periods after the initial recognition occurred.

Note that SFAC 7 is limited to measurement issues (how to measure); it does not address recognition questions (when to measure).

The factors that must be considered are:

- Risk – The probability that the cash will actually be paid or received.
- Timing – The periods in which the payments are expected to be received.
- Interest – The interest rates that would be appropriate, taking into consideration market rates and the credit standing of the parties involved.
- Amount of cash flows
  - Traditional approach – Use most likely cash flow amounts.
  - Expected approach – Use weighted average of different possibilities.

    > Cash flow has a 10% chance of being \$100, 60% chance of \$200, 30% chance of \$300.
    >
    > Traditional – \$200 (since it is most likely)
    > Expected – \$220 (10% × \$100 + 60% × \$200 + 30% × \$300)

  - When measuring a liability, one must look at the credit standing of the entity who owes the money.